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C O N F I D E N T I A L SECTION 01 OF 05 BAKU 000976

SIPDIS

DEPT FOR EB/ESC, EUR/CARC  
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DEPT FOR S/EEE AMB MORNINGSTAR AND DSTEIN  
DEPT FOR EB/ESC DAS DOUG HENGEL  
DEPT FOR S/CT FOR GROBERTSON, DKURSCH, CLARKS  
DOE FOR LEKIMOFF, MBURPOE, AND DGOTTFRIED

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TAGS: [ENRG](#) [EPET](#) [PREL](#) [TU](#) [RU](#) [AJ](#)

SUBJECT: AZERBAIJAN: SOCAR INSIGHTS ON BOTAS FINANCIAL  
PRESSURE, GAS NEGOTIATIONS

REF: A. BAKU 969  
    [B](#). BAKU 968  
    [C](#). BAKU 916

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Classified By: Political/Economic Chief Robert Garverick for  
Reasons 1.4 (B,D, E)

Summary

[11.](#) (C) In a lengthy December 15 meeting, SOCAR Vice President Elshad Nassirov provided details of his recent visits to Turkey on December 7 and Tehran on December 14-15 (reftel A). Nassirov analyzed the continuing difficulties with the gas negotiations as follows: BOTAS' driving motivation in the gas discussions with Azerbaijan was to avoid a deal which could be leveraged by Russia and Iran to negotiate lower gas transit costs for themselves. Nassirov also estimated that BOTAS has accumulated between \$3.5 and \$4 billion in arrears for take-or-pay gas commitments for gas deliveries it has pushed off until gas demand rebounds; the arrears endanger BOTAS' financial well-being, and reduce its appetite for expensive new gas contracts. Nassirov assesses the delayed delivery of this gas, likely in 2012, is another reason that Turkey continued push off a deal. Nassirov was also incensed to learn that the \$45 price offered by BOTAS for Italy Turkey Greece Interconnector (ITGI) transit was pegged to 2009 gas prices, and would not even be good until Shah Deniz II first gas was transported in 2016. Nassirov also urged the US to seek another formulation on Turkey-Armenian rapprochement, as he does not believe normalization is realistic, and an ensuing genocide resolution could cause the west to "lose Turkey forever."

Worried Genocide Resolution  
Could "Lose Turkey Forever"

¶2. (C) Nassirov started the conversation with an inquiry about Prime Minister Erdogan's visit to President Obama. He told Energy Officer that his sources indicated President Obama had told Prime Minister Erdogan that if Turkey-Armenia normalization was not achieved, then President Obama would not step in to prevent the springtime passage of genocide resolution (in the US Congress). Nassirov anxiously queried, "Is this true?" He cautioned, "Neither Turkey nor Armenia wants the border open. The US needs to look at other options. Success could be re-defined as "we've set them (Turkey and Armenia) on the path to normalization, now let's not interfere." Nassirov expressed worries that Turkey was on the verge of tipping into a Islamic fundamentalist state. He stated his firm position, "Only 23% of Turks approve of Erdogan's policy towards Armenia. If there is any additional push, like the genocide resolution, we (the west) could lose Turkey forever."

NK Garners More Attention in  
Wake of Turkey-Armenia Rapprochement

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¶3. (C) Nassirov did have one optimistic note: with the rise on the international agenda of Turkey-Armenian normalization, resolution of Nagorno-Karabakh - which remains Azerbaijan's driving policy concern - has garnered more attention than it had in years. He was modestly hopeful that this increased attention might force some progress on the NK stalemate. Nassirov opined that, "The Turks are in a delicate situation.

It would be best for Armenia to liberate the provinces outside of Nagorno-Karabakh." Looking at the Armenian side, he similarly concluded, "President Sargsian is also in a difficult position, he could easily be killed, he is not popular in Armenia." Nassirov concluded by reiterating Azerbaijani national ties with Turkey, stating "even if they

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open the border, we have no ally closer than the Turks."

Azerbaijan Not Obstructing a Deal,  
Turkey Acting Childishly

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¶4. (C) Nassirov adamantly rejected charges that Azerbaijan refuses to sign a gas deal now as a means to increase pressure on Turkey regarding its normalization process with Armenia. "I have spent three years of my life on these gas negotiations," Nassirov fumed. To the contrary, Nassirov again asserted that Turkey has become increasingly difficult in the gas negotiations, stating, "Azerbaijan is not obstructing a deal. A year ago, Turkey had only Azerbaijani gas, now it is acting more childishly because it has (prospects for) Iraqi and Iranian gas."

Turkish Concerns re Iran and Russia  
Block Deal for Azerbaijani Gas

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¶5. (C) Based on his recent trip to Turkey and related conversations, Nassirov offered new insights into BOTAS motivations on the gas negotiations. He stated the firm is afraid that any favorable gas deal inked with Azerbaijan will be used against Turkey by Russia and Iran. He also relayed concerns with BOTAS' growing billions in take-or-pay contract obligations for gas they have not been able to accept, in the wake of a dip in gas demand due to the financial crisis .

BOTAS in Hard Negotiations with Gazprom;  
Leveraging Low SD Gas Prices

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¶6. (C) Nassirov conveyed his recent discussions with "Deputy Medvedev" (presumably Deputy Chairman Alexander Medvedev), from the Gazprom Export company. Medvedev relayed to Nassirov that the Turks were demanding significant price concessions from Gazprom based on their existing low-priced

gas contract with Azerbaijan (Shah Deniz Phase I gas). The current Gazprom contract with Turkey for delivery of 6 billion cubic meters of natural gas (bcm, per annum) expires in 2011, and renewal negotiations are underway. Nassirov indicated that BOTAS has gone so far as to share with Gazprom its SOCAR Shah Deniz I contract, as leverage to demand reduced gas prices. Nassirov related that the BOTAS tactic appears to have been successful: Medvedev told Nassirov that Gazprom was ready to reduce its gas price to Turkey to re-secure the contract renewal. (Note: In past meetings, Nassirov has alluded to BOTAS being uncomfortable with sharing transit price calculations, afraid these would leak back to SOCAR's partners in the Shah Deniz consortium, which include Lukoil (via its LUKAgip partnership), and NICO, the Naft Iran Intertrade Company, a subsidiary of NIOC, the National Iranian Oil company. End note.)

**BOTAS: In Deep on the Take-or-pay Gamble**

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**¶7.** (C) Another factor is weighing on Turkey's appetite for new gas contracts. In a scene reminiscent of the *Sopranos*' 'executive gambling game,' Nassirov believes that BOTAS appears to have significantly over-extended itself at the take-or-pay betting table. That Turkey is over-contracted with gas for the current moment, likely until 2012, is well-known among industry watchers. Nassirov assesses that this situation has now impacted not only Turkey's willingness to contract additional gas volumes, but the take-or-pay financial cloud now threatens BOTAS' financial well-being. The firm now appears to be fighting hard in gas negotiations to regain its financial footing.

**BOTAS Take-or-Pay Obligations**

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**Could Total \$3.5-\$4 Billion USD**

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**¶8.** (C) Nassirov estimated that BOTAS has accumulated between \$3.5 and \$4 billion USD in take-or-pay gas obligations since the inception of the financial crisis caused gas demand in Turkey to plummet. Nassirov believes some or most of this is unpaid. According to Nassirov's estimates, the obligations include:

-- \$1.5 billion BOTAS debt to Gazprom  
-- \$1.6 billion BOTAS debt to NIGEC, the Iranian Gas Export Company  
-- \$0.8 billion BOTAS debt to SOCAR

Essentially, prior to the financial crisis, BOTAS over-contracted and has not been able to accept physical delivery of all of its gas purchases. Nassirov's calculations assume a pre-financial crisis gas demand in Turkey of 45 bcm, which he believes has fallen on average 15%, leaving 6-7 bcm/annum post-crisis of excess gas.

**¶9.** (C) Nassirov linked this surplus gas to Turkey's unwillingness to contract for new gas: Offering the Azerbaijani contract as an example, Nassirov noted that Turkey had to pay 80% up front for contracted volumes of gas, even if it did not accept physical delivery. The remaining 20% payment would be due upon delivery of the gas within a three-year period. With respect to the Azerbaijani gas contract, if Turkey does not accept the gas within three years, by 2012, its rights to it become void.

**Sobering Up from a Gas Hangover**

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**¶10.** Nassirov laid out the following schedule as he assesses medium-term Turkish gas demand:

2009 - Turkey was contracted for take-or-pay gas, including about 6-7 bcm for which it did not accept delivery;

2010 - gas demand forecast similar to 2009 demand, Turkey will not use contracted volumes, accruing 12 bcm in total excess gas;

2011 - With renewed growth, Turkey could accept 42-43 bcm of gas; however, it will utilize its 12 bcm of largely paid-for gas from 2009-2010, before buying new gas.

2012 - Turkey's deadline for accepting SOCAR take-or-pay gas from 2009.

Looking at this timeline, Nassirov asked rhetorically - in 2012, what should Turkey do? Having been burned so recently by take-or-pay provisions, Nassirov doubted whether Turkey would be eager to contract for new volumes of gas by 2012. While industry experts such as CERA have forecast that Turkey will flip into a gas deficiency by 2012, Nassirov seems to be wondering whether Turkey might simply try to make due in 2012 with accepting its overdue (and hopefully by then largely paid for) take-or-pay volumes from 2009-2011. (Note: The large unknown in this of course is how quickly the Turkish economy will recover from the financial crisis, and bounce back or surpass pre-crisis gas demand levels. End note.) Thus, Turkey continues to play hard ball with Azerbaijan on the transit negotiations.

#### Negotiation Details

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¶11. (C) On the specifics of the gas negotiations, Nassirov reiterated earlier comments that Azerbaijan and Turkey had largely reached agreement on Shah Deniz I and II prices

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(reflets). BOTAS has agreed to payment of arrears accumulated on Shah Deniz I gas. Azerbaijan in turn has obtained approval from Shah Deniz consortium members to an approximately \$45 transit tariff. Nassirov outlined a more specific breakdown of the tariff, basing it on a transit rate of \$2.60 USD/100 km/thousand cubic meters (tcm) of gas, across the territory of Turkey. He noted, with some irritation, that the Turks called the tariff "exceptional" in their last meeting.

#### No Further Along on Transit Cost Release

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¶12. (C) Nassirov reiterated his frequent complaints that the Ministry of Energy did not know how the transit figures were calculated, and BOTAS remained unwilling to share the information. Since the early December meetings with Minister Yildiz, Nassirov has discussed the transit fee issue with BOTAS's Seljuk Advan, BOTAS Head of Natural Gas Purchasing and Export. Advan continued to claim he did not have permission to share the data, despite Minister Yildiz's early December commitment that BOTAS would do so. (reftel B)

#### Fuel Gas Major Sticking Point; Costs will Climb into Billions

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¶13. (C) There are also disagreements on the percentage of fuel gas required to operate the Italy Turkey Greece Interconnect (ITGI) pipeline. BOTAS is pushing for a high figure of 5% of gas transported, while SOCAR believes the cap is closer to 3%. Nassirov estimated \$160 million annually for the fuel gas to operate the pipeline, a figure which will climb into the billions over the pipeline's 30-year projected lifespan.

#### How to Index Fuel Gas Price Increases?

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¶14. (C) Indexation of transit cost increases for fuel gas have remained a sticking point for the last several weeks.

BOTAS' Seljuk Advan has demanded automatic price increases indexed to inflation, as well as to natural gas price increases. Given the relatively high price SOCAR believes it is paying at the inception of the contract, SOCAR continues to resist the gas price indexing. Nassirov was also incensed to learn that the \$45 transit price offered by BOTAS was pegged to 2009 gas prices, and would not even be good until Shah Deniz II first gas was transported. In 2016, when SD II started producing and transporting gas, the initial transit figure could have already risen to \$65, \$70, or even \$80, he complained.

SOCAR Pushes Automatic Arbitration in Face of Fuel Gas Price Disputes

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¶15. (C) SOCAR also continues to push for a mechanism for automatic referral to arbitration, in the case of a prolonged dispute on gas price increases for ITGI. SOCAR has proposed various formulations, most recently an automatic referral to arbitration if price increase negotiations drag on longer than 6 months. Nassirov told us that while BOTAS took the arbitration clause to Ankara for approval, Turkish Energy Minister Yildiz deemed it not acceptable. SOCAR is determined to avoid a repeat of the Shah Deniz I gas price scenario, in which BOTAS accumulated enormous arrears when the parties were unable to agree to a new gas price in the face of surging world gas prices.

Political Fears Tied to Reluctance to Arbitrate

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¶16. (C) Nassirov explained that SOCAR and BOTAS have avoided taking the Shah Deniz I pricing gas price dispute to arbitration, for fears that the case could prove politically difficult for both governments. SOCAR had hoped implementing an automatic referral to arbitration would reduce this pressure, and make transform arbitration back into what it was intended to be - a simple commercial dispute resolution mechanism, rather than a "coming to blows" between the close Turkic brothers. To insulate Azerbaijan's key relationship with Turkey, Nassirov has proposed various formulations to ensure any recourse to arbitration would involve BOTAS and SOCAR alone, and not the national governments.

Comment

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¶17. (C) The figures on BOTAS take-or-pay obligations, if accurate, are enormously large for a firm with a net income of about \$104.6 million USD ( 160,950,329 Turkish lire) at the end of 2008 (BOTAS website, income statement table). Embassy Baku would welcome additional input from Embassy Ankara or Washington on Nassirov's figures, and the role that BOTAS' financial condition may play in driving their gas negotiations with SOCAR. Nassirov is frustrated, but remains committed to the gas discussions. Nonetheless, he continues to advocate an open mind towards other alternatives, a point we will explore septel.

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